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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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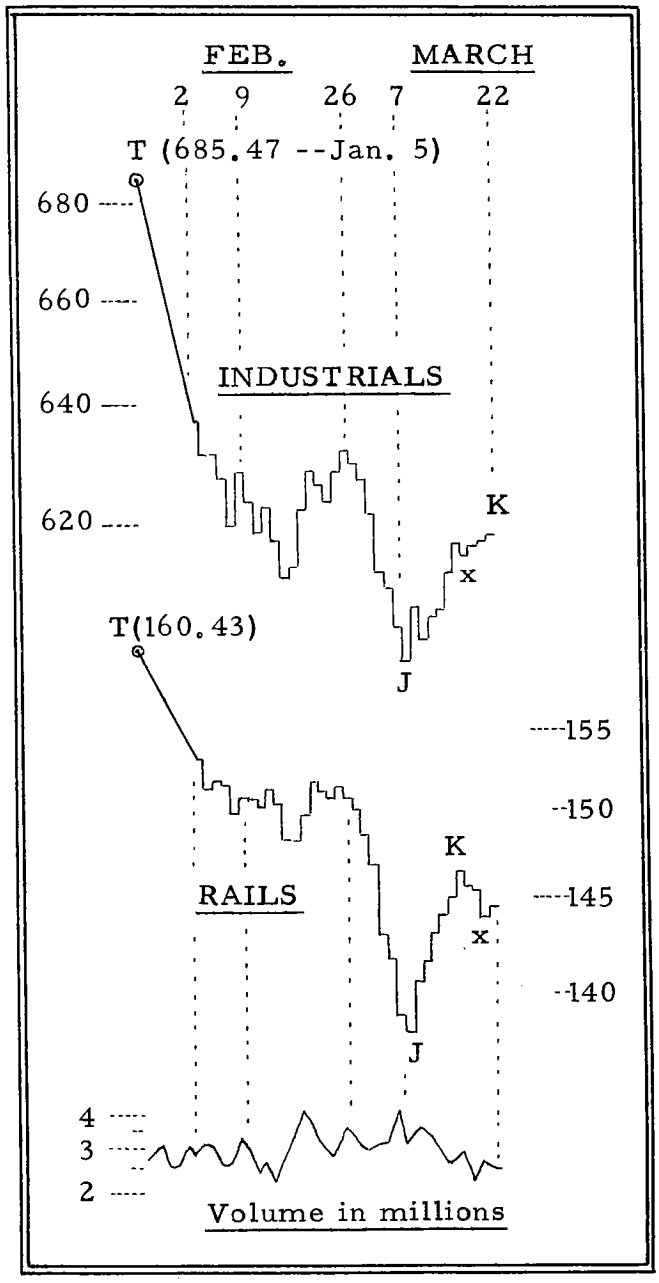
PRICE MOVEMENTS. On the rally from J volume remained low, seeming to grow increasingly dull as prices worked higher. Industrials and Rails touched 616.73 and 146.51 (K on Rails) respectively on March 16. Following a one-day decline, Industrials continued their advance, and the senior Average hit 618.09 on March 22 (K on Industrials). This Industrial move was not confirmed by Rails, and, in fact, the carriers diverged (moved in the opposite direction) on March 18 and 21.

A Rail bettering of their own K point (146.51) on increasing volume would suggest a further advance and the possibility of a normal 1/3 to 2/3 retracement of the losses sustained since the January 5 highs. Conversely, if Industrials and Rails violate their previous decline points at X (Industrials 615.09, Rails 143.98) on increasing volume it would imply a testing of the J lows (Industrials 599.10, Rails 138.18). A joint violation of the J lows would signal a resumption of the recent downtrend.



It is a common occurrence, following a bear market rally, for a "line" to form in the Averages. Such a line, wrote Hamilton, "thoroughly tests the public absorption power. On a serious break.. there is always heavy buying in support, to protect weak accounts too large to be liquidated, and this stock is fed out on a recovery. It is largely offset by the covering of shorts and bargain buying, but if the absorption power is still lacking there is a further and slower decline, usually establishing new low points." If a line is now being formed, it is possible that the weaker stocks will be distributed under the guise of "firmness" in the D-J Averages. In the event of a line, I will discuss the situation further in the next Letter.

The primary trend or tide of the market is down. The secondary trend is also down, while the minor trend (because of the divergence) is obscured. A series of two or more upward zigzags in both Averages would signify that the secondary trend had turned up.

In reading a number of recent brokerage house letters, I notice that they all stress the absence of high volume or selling pressure on the downside. This they take to be bullish. Most of these writers are "familiar" only with the bear markets of 1929, 1937 and 1946, but readers who own charts of the

Averages (1896 to the present) may observe that many of the bear markets which came prior to 1929 showed deceptively little liquidating volume as compared to later markets.

Hamilton and Rhea always gave priority to the price movement itself while using volume as an aid in interpreting the price action. I do not feel that one should be dogmatic as to what "has to be" in the way of volume. As a general rule when, after a bear market rally there is a slight decline, following which one or both Averages fail to better the previous peaks as volume goes dull, it is a sign that the rally is about over. This, as mentioned previously, is the classic "sell-spot" in a bear market.

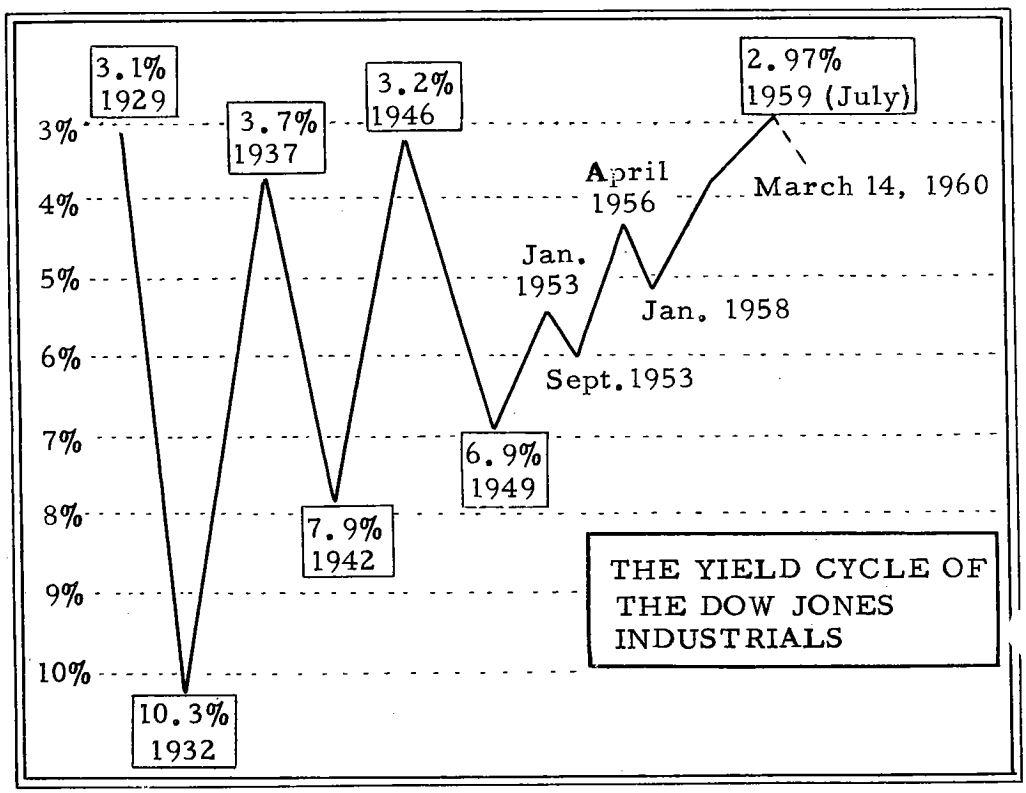
Neophytes are often tempted to draw conclusions from a single day's action, particularly when those conclusions fit in with their own preconceived notions. Such procedure is usually costly. Traders should train themselves to study the overall appearance of the market over a period of time. For instance, on the rally since J the market has not, as yet, been able to gather a "following". This can be seen from the fact that volume has remained dull throughout, seeming to stabilize at about 2.6 million shares. This dullness on the rally is hardly a "plus" sign for the bulls.

Judging by correspondence, a few readers seem to believe that I possess "trade secrets" which I use to draw conclusions regarding the trend. I only wish that I did. But unfortunately, I only follow the Averages while doing my best to interpret their movements. I continue to take the pattern of the Averages together with the recent third phase indications to mean that we are in a primary bear market. I do not see how any serious student of Dow's Theory can argue differently.

DOW AND VALUES In the last Letter I wrote that bear signals are valid only when they come after the third phase of a bull market. I also listed some of the phenomena which characteristically identify a bull market's third phase. One of the more important items on that list was "low yields".

Few people are aware that Dow himself stressed values above everything else -- even above the price movements. "To know values," wrote Dow, "is to know the meaning of the movements of the market." Again he wrote, "Stocks fluctuate together, but prices are controlled by values in the long run."

Dow correctly noted that one important test of value is yield or return on investment. Regarding yields Dow said, "When a stock sells at a price which returns only about 3 1/2% on the investment, it is obviously dear, except there be some special reason for the established price. In the long run, the prices of stocks adjust themselves to the return on investment, and while this is not a safe guide at all times, it is a guide that should never be laid aside or overlooked." (Wall St. Journal, 1902).



While on the face of it, this statement may appear naive, a study of history shows that Dow's original observation concerning yields has proved remarkably accurate. Note (on chart) that every extended bull market in modern history has topped when, and only when, the average yield on the thirty "blue-chip" D-J Industrials entered the 3 1/2% area.

The reason for this is that consciously or unconsciously, informed investors will distribute their stocks when those stocks advance beyond their line of values. Certainly, the action of the market over the past sixty years backs up Dow's thesis that common stocks in the 3 1/2% yield zone are not values.

Note that at the time of the "1953 bear signal" the average yield on the D-J Industrials was a whopping 5 1/2%. Later when the "1957 bear signal" was given, the average yield on the D-J Industrials was in the 4 1/2% area. Yet no extended bull market in modern history ever topped with the average yield on the D-J Industrials above 4%. During July and August of 1959 (the bull market top), however, the average yield on the Dow had actually dropped to 2.92% (it had been under 4% ever since December of 1958). In other words, stocks had ceased being values in mid-1959, and seasoned investors had every reason to be distributing.

As we might expect, the yield cycle invariably swings to the opposite extreme during bear markets. Thus at the 1932, 1942 and 1949 bear market bottoms the average yield on the D-J Industrials climbed to 10.3%, 7.9% and 6.9% respectively. One of the tests of a bear market bottom is that stocks in those areas always sell below known values. This implies yields on high-grade equities of 6% or better. At some time in the future when good stocks are again in the 6% plus area of yield, we can be sure that investors who know values will begin accumulating. This accumulation of values is exactly what provides the base for the next bull market.

FACTS and FICTION. I have never claimed infallibility for Dow's Theory nor have I claimed an extraordinary personal talent in its interpretation. Nevertheless, I am amazed by the sudden emergence of dozens of new "Dow Theory experts", many of whom have become "well-versed" in the Theory in the few weeks since the bear signal. A favorite pastime of the new students seems to be the publishing of incorrect listings of previous bull market tops and bear market confirmations (all in an attempt to prove that investors should hold sound equities through bear markets rather than sell). The current decline cannot be a bear market, say the new interpreters, because fundamental business conditions are still too good. But if this were a bear market, they conclude, look what happened to people who sold on previous bear market confirmations.

In answer, I might say that business conditions are always excellent at a bull market top (and even after the actual bear signal). It also might be helpful to place the statistics concerning previous bear markets in context. The bear market figures listed below show that the average percentage of loss sustained by Industrials in all bear markets (both mild and severe) was about 32%. The average loss in Industrials after confirmation was about 22%. BUT note that where the preceding bull market was extended, the subsequent bear market losses were more severe. Thus of thirteen completed bear markets since 1896, seven showed Industrial losses of 40% or more. And although no true Dow Theorist ever waits for the actual bear signal in order to sell, six out of the thirteen bear markets showed Industrial losses after the bear signal of 32% or more. Moreover, in almost all bear markets the high-quality Dow stocks held up better than the general market.

Since I have always stressed (1) safety of principal and (2) the desirability of paying "the cost of insurance" against possible severe losses, it seems to me that the record of the past backs up the wisdom of avoiding bear markets where possible.

A RECORD OF THE D-J INDUSTRIALS THROUGH 13 BEAR MARKETS

From	To	No. of legs in bear mkt.	Total days of decline	Total % of decline	Total pts. decline	Bear mkt. confirmed	Pts. lost after confirm.	% Decline after confirm.
4/4/99	6/23/00	4	445	29.4	22.36	12/16/99	10.16	15.91
9/19/02	11/9/03	3	416	37.8	25.62	6/1/03	17.44	29.26
1/19/06	11/15/07	4	665	48.5	50.00	4/26/06	39.44	42.66
11/19/09	7/26/10	2	249	26.8	26.91	5/3/10	11.10	13.10
9/30/12	12/24/14	4	815	43.5	40.98	1/14/13	31.79	37.41
11/21/16	12/19/17	3	393	40.1	44.20	8/28/17	20.17	23.42
11/3/19	8/24/21	6	660	46.6	55.72	2/3/20	36.06	36.07
9/3/29	7/8/32	8	1039	89.2	339.95	10/23/29	264.63	86.52
3/10/37	3/31/38	3	386	49.1	95.47	9/7/37	65.44	39.80
11/12/38	4/8/39	2	147	23.3	36.97	3/31/39	10.40	7.88
9/12/39	4/28/42	3	959	40.4	63.00	5/13/40	44.71	32.48
5/29/46	5/17/47	3	353	23.2	49.29	8/27/46	27.83	14.56
6/15/48	6/13/49	4	363	16.3	31.56	11/9/48	12.34	7.09

I am again quoting from Mr. Humphrey B. Neill's thought provoking "Letters of Contrary Opinion".

"Denials of the Dow Signal: As everyone knows, from the publicity it has had "from coast to coast," the Dow Theory has signalled a primary bear market and probable business recession. As contrarians, I think we should make serious note of the fact that never before has the Dow Theory been so widely ridiculed - nor the bear-market signal so universally scoffed at and derided.

> It is really extraordinary how financial writers all over the country - in newspapers, weekly magazines, brokers' letters and in advisory-service bulletins - literally tore into the Dow Theory explaining (?) to their readers that it was a snare and a delusion.

For this reason, I urge you to give the recent Dow signal serious consideration. The extreme attack on the Dow Theory has undoubtedly led the "crowd" and others who should know better into believing the decline is completed and ahead lies the blue sky of speculative fortunes. Wall Street was never as easy to conquer as that! A further recovery over the near term would serve to strengthen this false optimism."

STOCKS. In general, the D-J Industrials continue to look better than the market. The following Dow stocks have not yet broken important support. The important support points are listed after each stock. American Tobacco - 101, General Electric - 84, Westinghouse - 45, Owens-Illinois Glass - 92, General Foods - 93, Texaco - 71, Proctor & Gamble - 81, Eastman Kodak - 84, Sears - 44, Swift - 45.

(Written March 23 - at noon)